

THE PROGRESS REPORT

Tax Reform

By Fred E. Foldvary

April 15 is the American anti-holiday. It is the dreaded deadline for filing income taxes and paying the balance due. The average taxpayer has to work until mid May just to pay his income tax. The burden of the income tax is not just the money paid but also the enormous time spent filling out the forms. Americans spend several billion hours per year doing their income taxes, the equivalent of 3 million people working full time just on taxes. On top of this social cost, there is what economists call the "excess burden" on the economy from reducing the wealth and growth we could have if not for the income tax.

Besides the regular burden, some unlucky Americans face penalties, "interest" and audits that sometimes destroy businesses and lives. In 1992, the IRS imposed 33 million penalties on taxpayers, often for trivial errors or no errors at all. There are 9000 pages of the U.S. Statutes at Large on income tax regulations, and the tax laws are continuously changing. For the agonizing details on the effect of the income tax on Americans, see the chapter on "Taxing and Tyrannizing" in *Lost Rights* by James Bovard.

Even without the abuses and complications, today's federal income tax skews economic decisions into inefficient patterns. One example is that explicit flows of income are taxed, leaving implicit income, such as unrealized gains, untaxed. If you own an asset such as stocks, the annual gains are not taxed until the asset is sold. Decisions on buying and selling property are then timed to minimize the impact of taxes rather than when personal and financial considerations would determine the best timing.

It's bad enough that real income is taxed, but the government also taxes pseudo income. Inflation is not taken into account in calculating "income." If you have \$100 in savings and earn \$5 interest and inflation is 3 percent, your real gain is only \$2 after the \$3 inflation is subtracted. But a 40 percent income tax applies to the whole \$5, so the \$2 tax eliminates all the real gain. Depreciation is also not indexed for inflation, making the deductions smaller than they should be.

On top of the burdens of federal corporate and personal income tax are the state income taxes, sales taxes, and taxes on constructed property. In their chapter "Taxed out of Work and Wealth: the Costs of Taxing Labor and Capital," Nicolaus Tideman and Florenz Plassman estimate that the total excess burden (beyond the money paid) of taxes are about \$1 trillion per year.

How did America, the "land of the free," get stuck with such a tax monstrosity? Before the US Constitution was adopted, the Articles of Confederation provided for taxes to be paid "in proportion to the value of all land within each state" (Article VIII). Had this been continued in the US Constitution, we would have avoided many of the social problems that later faced the country. But alas, the framers of the US Constitution instead provided for direct and indirect taxes, direct taxes being apportioned by population.

The US government collected direct taxes on real estate several times to pay for war expenses, and attempted this again in 1861, but the western states objected, saying that they would face a greater per-capita burden than the wealthy eastern states. So the government switched from a direct tax on real estate to the income tax, without apportioning it by population.

This income tax expired in 1872, and was brought back in 1894 as a alternative to regressive consumption taxes. But in 1895 the US Supreme Court declared the income tax to be unconstitutional, not being totally indirect. The 16th Amendment to the US Constitution then authorized the US government to impose income taxes without regards to enumeration or population per state, the US Supreme Court declaring that the Amendment makes the income tax legally an indirect tax on the activity and privilege of obtaining income.

Some people defend income taxes as spreading the burden out among the public, but much of the burden falls on the middle-income workers, not poor enough to avoid taxes, and not rich enough to hire tax lawyers and accountants to shelter income. Much of income from rent is sheltered by legal fictions such as the "depreciation" of the improvements and by rolling over gains to new properties.

Instead of trying to spread out the burden, why not eliminate the tax burden entirely? All this paperwork, audits, and invasions of privacy can be eliminated by shifting to user fees and assessments on land rent. The revolutionaries who wrote the Articles of Confederation had the right idea: base public revenue on land value or land rent. Each landowner gets sent a monthly bill, and there are no forms to fill out and no audits. When we get public finance from rent instead of wages and capital yields, we get both more productivity and more equality.

Why do Americans burden themselves with an income tax instead of getting public revenue from rent? The basic problem is massive ignorance. They don't know, and they don't know that they don't know. In some more enlightened day, folks will look back and wonder why a democratic society inflicted itself with such a burdensome, incomprehensibly complex, and traumatic tax system